United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

No. 74-1697

United States Court of Appeals
For the Second Circuit

SIRBO HOLDINGS, INC.,
PETITIONER, APPELLANT,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT, APPELLEE.

ON APPEAL FROM THE UNITED STATES TAX COURT

APPELLANT'S REPLY BRIEF

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By ignoring how the $125,000 figure was arrived at, and what it was intended to compensate for, the government's brief does not fairly present the issue.

The issue is the nature for income tax purposes of a single $125,000 payment made in 1964 by the lessee (CBS) to the lessor-taxpayer (Sirbo), which they both viewed as payment to Sirbo for CBS's removal of fixtures, etc. and other damage to the leased premises attributable to CBS, occurring over the preceding sixteen years of its leasehold occupancy.

The government's brief, however, argues (page 17):

> "In this case, we believe it clear that the $125,000 received by taxpayer from CBS for discharge of the latter's obligation to restore the theatre to its 1947 condition were not proceeds of a sale or exchange. This Court in Graham v. Commissioner, 304 F. 2d 707, 708 (1962), recognized that 'It is well settled that the payment of an obligation cannot be a 'sale or exchange,'' and so held."

Graham v. Commissioner, supra, has little visible relevance to the instant case. The instant case is concerned with the broad language of Section 1231, entitled "Property Used in the Trade or Business and Involuntary Conversion". Graham does not

deal with Section 1231. Graham is concerned solely with the restrictive language of Section 1232, dealing with the retirement of "Bonds and Other Evidence of Indebtedness" issued by a corporation, or by any government or political subdivision thereof. The taxpayer in Graham, an investor or speculator, had purchased at a judicial sale for a nominal sum part of a monetary "award" made by the German-American Mixed Claims Commission. The Court of Appeals for the Second Circuit held: (1) this "award" had not been "issued" by a "government or political subdivision", within the special meaning of Section 1232; and (2) this award in any event did not comply with the further requirement of a Section 1232 "obligation" that it have interest coupons attached, or be in registered form.

Whether or not the discharge or payment or "extinguishment" of a contract "obligation" that is unrelated to the transfer or surrender of any property interest by the recipient of the payment, may constitute a "sale or exchange" is not necessarily determinative of the issue in this case. Cf. Commissioner v. The Pittston Company, 252 F.2d 344 (C.A. 2, 1958), cert. denied 357 U.S. 919 (1958). That is, the discharge or payment or "extinguishment" of a contract obligation having its origin in the prior transfer or surrender of a property interest is quite another matter. To illustrate, consider a taxpayer who transfers or surrenders his interest in a capital asset under a contract calling for part payment in the year

the contract is entered into, with final payment deferred to a subsequent year. In the subsequent year when final payment is made, there is indeed merely an "extinguishment" of a contract obligation of the payor. Yet no one would seriously contend that the government's invocation of "extinguishment" terminology in that year would or could convert proceeds received in that year from capital gain to ordinary income. The Supreme Court holds that in determining the income tax character of a payment attention must not be confined only to events that occur in the year of payment, but events of earlier years constituting the originating cause or reason for the payment, viz. what it was for, must be looked at. Cf. Lyeth v. Hoey, 305 U.S. 188 (1938); Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

The reason for the $125,000 payment in 1964 was to pay Sirbo for actual damage its lessee (CBS) had caused to Sirbo's property over the preceding sixteen (16) years, from 1947 to 1963. Under its original lease entered into with Sirbo, CBS had only a potential contract obligation relating to restoral. This potential contract obligation was contingent upon the occurrence of yet another event before CBS became actually obligated under this provision; this other event was that after the commencement of their leasing relationship, CBS had subsequently changed or damaged Sirbo's property.

The government's brief itself recognizes that it was CBS's changes to the leased premises that gave rise to Sirbo's later claim for $125,000. Thus, the government's brief states (page 4):

> "It was understood [at the commencement of the leasing relationship in the early 1940's] that extensive structural and non-structural changes might be made. (R. 211) At this time, however, CBS was using the theatre as a radio studio, and this required very little change. (R. 85)"

The government's brief then goes on to state (page 6):

> "Some time after November 14, 1947, CBS began to make changes in the physical arrangement of the theatre in order to adapt it for use by CBS as a television studio. These changes included the removal of approximately 300 to 400 theatre seats, the elimination of all carpeting, chandeliers and stage curtains; the extension of the stage area into what was formerly the audience area, a change in the floor level and the elimination of the 'loop' in the former seating arrangement, the construction of walls and partitions and appropriate structural changes to accommodate control rooms, the alteration of bathrooms and the heating system, and the installation of thousands of feet of electrical wiring. (R. 213-214)"

The government's brief, and the Tax Court opinion, both seriously distort consideration of the tax nature of this $125,000 payment by failing to consider the crucial fact that just before

the payment in question was made, CBS and Sirbo both obtained expert appraisals to determine the extent of CBS's changes to Sirbo's property. (R. 87, 191, Ex. 12; R. 40-45) The $125,000 figure was the product of a compromise of these two appraisals, one of $70,000 and one of $200,000. (R. 40-42, 87-90, 187-191)

Although both Sirbo and CBS--and this Court of Appeals in its prior opinion--thus understood the $125,000 payment to be compensation for CBS's removal of Sirbo's fixtures, etc., the government brief now blandly assures all parties concerned that they are in error. The government's brief states (pp. 18, 19):

> "This Court appears to have assumed on the prior hearing that CBS had an obligation to pay for the used seats and other items of equipment that were removed from the theatre, and that part of the $125,000 payment was in discharge of that obligation. (S.R. 14-15.) But the record offers no support for that assumption, and contains at least two indications that it is erroneous."

The first "indication" so relied on (government brief, pp. 18, 19) is that "there is no showing in the record of the disposition of the used seats, etc. when removed from the theatre" and "they may have been delivered to the taxpayer for storage and re-installation...." The government brief writer has failed to read this record in its entirety. The record contains clear evidence

that Sirbo obtained no financial benefit whatsoever from CBS's removal of Sirbo's fixtures. (R. 52, 53)[1]

The second "indication" relied on (government brief, pp. 19, 20) is "the taxpayer itself did not treat the equipment removed from the theatre as sold to CBS" but continued to depreciate all its property as before.

In so doing Sirbo was simply following a depreciation practice that the Commissioner of Internal Revenue has insisted should be followed when, as here, a taxpayer (Sirbo) has purchased for a lump-sum a used building and land pertaining thereto. In Rev. Rul. 66-111, C.B. 1966-1, 46, 47, the Commissioner took this position:

> "When a used building is acquired for a lump sum consideration, separate components are not bought; a unified structure is purchased. The individual components of a used building are not sold separately and hence are not ordinarily subject to fair market value determinations for allocation of basis or for depreciation purposes. The value of components (ceilings, floors, electrical systems, etc.) of a used building cannot be separated from the value of the building as a whole since their values exist only in connection with the building as a whole."

---

[1]The very fact that CBS was willing to pay Sirbo $125,000 for "the partially-destroyed premises" of Sirbo is itself a clear indication Sirbo in no way benefitted from CBS's removal of the fixtures. (R. 187-189)

Only recently, in October 1973, some ten years after the close of the taxable year now under review, the Commissioner somewhat modified his position. Rev. Rul. 73-410, 1973-41 I.R.B., at page 8, modifying Rev. Rul. 66-111. It is, however, ironic that Sirbo should now be faced with a contention of the Commissioner that because Sirbo, during the years at issue, followed a depreciation practice the Commissioner himself required Sirbo to follow, Sirbo should now (government brief, pp. 19, 20) be "estopped" from claiming Section 1231 treatment for the $125,000 it received in 1964.[2]

The government's brief (pages 20, 21) also refers to an alleged third "indication" that this $125,000 payment was not really a payment for fixtures, etc. belonging to Sirbo that CBS removed or destroyed or damaged, between 1947 and 1963. The government argues that under a written proposal that CBS made (Ex. L; R. 204, 205) to Sirbo, dated December 24, 1963, CBS would leave "seats, carpets, and other theatre equipment" (but not CBS's "technical gear") on the premises at the expiration of a new lease about to be entered into

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[2]Sirbo's certified public accountant, testifying at the Tax Court trial of this case in 1971 (R. 1, 110, 111), before the issuance of this modifying Revenue Ruling 73-410, testified also that "good accounting practice" did not require an allocation of Sirbo's purchase price for the building among the building components.

covering the future period from January 1, 1964 to December 31, 1968, inclusive. The government brief then jumps to the unwarranted assumption that Sirbo's compensation for equipment removed by CBS, from 1947 to 1963, was not the later $125,000 cash payment, but the "seats, carpet, and other theatre equipment" that CBS proposed to leave behind it, five years later, on December 31, 1968. The answer to this argument is that this record shows Sirbo did not agree to this proposal of CBS, embodied in Exhibit L. (R. 98-100; Ex. L, R. 204, 205) The parties instead agreed on cash compensation, early in 1964, for what CBS had done to Sirbo's property between 1947 and 1963, ultimately compromised out at the figure of $125,000, and reflected in a later executed document dated as of December 31, 1963. (Ex. 11; R. 187-190). In consequence of this $125,000 cash payment, reflected in this separate agreement, the new lease (Ex. 7-G; R. 184a-184d) that the parties entered into, covering the future years 1964 to 1968, inclusive, did not track the language of CBS's earlier rejected proposal (Ex. L; R. 204, 205) requiring CBS to leave "seats, carpets, and other theatre equipment" on the premises on December 31, 1968.

The Commissioner's brief before this Court of Appeals is remarkable for its partisan question-begging. For example, the government brief states (page 17):

> "Of course, if CBS had bought, and were paying for, the used seats, carpets, chandeliers, and stage curtains that were removed from the theatre, then some small part of its $125,000 payment might, under Section 1231, give rise to capital gain from the sale of depreciable property used in trade or business, provided taxpayer had supplied evidence to support an allocation of price and basis. But the record in this case, in the original hearing and after remand, contains nothing to supply either element necessary to support taxpay[illegible]s claim." (Emphasis supplied)

The Commissioner's brief does not explain why, in such circumstances, only a "small" part of this $125,000 should give rise to capital gain. Later in the Commissioner's brief (page 21) the unexplained assumption appears again that "only a miniscule part of the $125,000" could be attributed to compensation of Sirbo for removed fixtures, and damage to its property. Such partisan characterizations do not reflect this record, showing how Sirbo and CBS viewed the makeup of the $125,000 compromise payment. (R. 40-42, 87, 187-191)

Again, the government brief writer apparently failed to study adequately the entire record, in view of the allegation (government brief, pages 18, 22) that taxpayer offered no evidence to support an allocation of basis applicable to the removed or destroyed property. Sirbo offered lengthy testimony of two witnesses, a Certified Public Accountant (Alexander Aschengrau) and a real

estate appraisal expert (Frederick E. Marx) bearing on a proper allocation of basis. (R. 104-147, 196, 201; Ex. 14, Ex. 16)

Even had Sirbo failed to prove a proper "basis" for its damaged, destroyed, or removed property, this would not justify treatment of the $125,000 as ordinary income. The issue of "basis" relates to the measurement of gain only; it has nothing to do with the characterization of gain or income. In the event of such a failure relating to a proper allocation of "basis", the only adverse consequence to Sirbo would be that a zero "basis" would have to be assigned to its damaged, destroyed, or removed property, with the result that the entire $125,000 would become taxable to Sirbo as all gain, or all income. But its nature, that is, whether the $125,000 gain or income should be treated as capital gain under Section 1231, or as ordinary income, would not be controlled, or even affected, by Sirbo's being compelled to use a "zero basis". In United States v. Pate, 254 F.2d 480 (C.A. 10, 1958) a taxpayer having a "zero basis" for assets was nevertheless held entitled to the benefits of Section 1231(a). Reg. 1.1231-c(1), set out at pages 55 and 56 of appellant's original brief, indicates that Sec. 1231 treatment is applicable even to a fully depreciated asset, that is, one having a "zero basis".

II

The government's brief ignores the substantial issue in this case, noted in the previous Court of Appeals opinion.

In its earlier opinion in this case, this Court of Appeals noted a conflict in its own opinions as to whether a "release" could constitute a "sale or exchange". In reversing the Tax Court, this Court of Appeals then directed that attention should be given to the question of whether "sale" in Section 453 was a narrower concept than "sale or exchange" in Section 1231.

The government brief (pp. 22, 23) in effect now represents that this appellate court's interest in the respective scope of Section 453, as contrasted with Section 1231, "seems irrelevant" to the decision of the instant case since "the Billy Rose panel of this Court clearly intended no differentiation...."

This argument misses the point completely. As this Court of Appeals noted in its earlier reversal of the Tax Court opinion in the instant case, the "Billy Rose panel of this Court" never had any argument made before it concerning the possible applicability of Section 1231, and the interplay of Section 1231 with Section 453. See in this connection pages 20, 46 and 47 of appellant's original brief. Thus, there was no necessity for

"the Billy Rose panel of this Court" even to consider the scope and meaning of Section 1231, which is the main issue in the instant case.

The government brief (page 23) takes appellant's counsel to task for emphasizing that "sale or exchange" in Section 1231 postdated the installment sales provision (now Sec. 453) by sixteen years, and for suggesting that Section 1231 may have a different scope. The government brief assumes and suggests that "sale or exchange" has a well-established meaning, one that dates back to 1921.

This assumption does not square with the case law. "Sale or exchange" is not a rigid, fixed concept, but one that has been liberalized and expanded over the years, and one that depends for its true meaning on its specific statutory setting. Thus, the Supreme Court in 1941 held that an "involuntary conversion" by fire was then not a "sale or exchange". Helvering v. Flacc[illegible] Leather Co., 313 U.S. 247. Today, in 1974, it holds that an "involuntary conversion" by fire is a "sale or exchange". Central Tablet Manufacturing Co. v. United States, (No. 73-593) 42 L.W. 4961. The lower court cases indicate that an "involuntary conversion" is a "sale or exchange", for purposes of Section 337 and Section 392. Towanda Textiles, Inc. v. United States, 180 F. Supp. 373 (Ct. Cls.,

1960); Kent Mfg. Corp. v. Commissioner, 288 F.2d 812 (C.A. 4, 1961). On the other hand it has been held that an "involuntary conversion" is not a "sale or exchange" for purposes of Section 1238, in view of the particular legislative history of that provision. Chicago, Burlington & Quincy R. Co. v. United States, 455 F.2d 993 (Ct. Cls., 1972).

It is interesting and ironic that the government's brief (page 28) should now attempt to limit the Supreme Court's recent acceptance of a liberalized definition of "sale or exchange" (Central Tablet Mfg. Co. v. United States) to cases involving Section 337. This is interesting and ironic because the cases cited by the Supreme Court as originally giving rise to this now approved liberalized definition of "sale or exchange" in Section 337, in turn relied on the liberalizing thrust of Section 1231. Towanda Textiles, Inc. v. United States, supra; Kent Mfg. Corp. v. Commissioner, supra.

III

It may not be necessary for this Court to resolve the apparent conflict in its decisions that it noted in its previous opinion in this case.

If this Court concludes, as taxpayers have demonstrated, that the $125,000 payment by CBS to Sirbo was for depreciable business property of Sirbo, described in Section 1231, that CBS removed, destroyed, or damaged, then it need not resolve the apparent conflict in its opinions that the Court itself has noted, that is, whether the "release" of a naked contract obligation is a "sale or exchange". In short, if the $125,000 payment was for such property, then *a fortiori* it was not for the "release" of a naked contract obligation.

Only if this Court decides that the $125,000 was for release of a naked contract obligation, unrelated to Sirbo's previous transfer or loss or surrender of an interest in property, will the conflict emerge that the Court noted in its previous opinion in this case.

CONCLUSION

The Tax Court opinion and decision in this case should be reversed and remanded with directions that Sirbo be granted long-term capital gain treatment with respect to the income or gain element in the $125,000 payment by CBS, i.e., the excess of $125,000 over Sirbo's properly allocable "basis" for its property removed or damaged by CBS. (S. R. 19, footnote 9)

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that service of this Appellant's Reply Brief was made on Respondent, Appellee on October 18, 1974, by mailing three copies thereof, postage prepaid, to its counsel at the following address:

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October 18, 1974

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Dear Sir:

Herewith are twenty-five copies of the Reply Brief for the Appellant in No. 74-1697,

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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent, Appellee.

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